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IN THE

Supreme Court of the United States

OCTOBER TERM, 1950.

No. 193

WHITE BROTHERS COMPANY,

Petitioner,

versus

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

FRANK S. NORMANN,
Attorney for Petitioner.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Petitioner, White Brothers Company, prays that a writ of certiorari issue to review the decision of the United States Court of Appeals for the Fifth Circuit entered in the above case on March 9, 1950, affirming the Judgment of the Tax Court of the United States.

OPINIONS BELOW.

The findings of fact and conclusions of law of the Tax Court of the United States (R. 71-77) are not officially re-

ported. The opinion of the Court of Appeals for the Fifth Circuit (R. 91-96) is reported at 180 F. 2d 451. Petition for Rehearing was filed on March 30, 1950 (R. 98-101) and denied on April 10, 1950 (R. 102).

JURISDICTION.

The jurisdiction of this Court is invoked under Judiciary and Judicial Procedure, Title 28, U. S. C. A., Section 1254(1). Under Section 2101(c) of the same title, time for applying for this writ of certiorari expires on July 9, 1950.

QUESTION PRESENTED

Do the applicable sections of the Internal Revenue Code (Secs. 44, 11[illegible](1), 718, 728 and 736) authorize the findings of the Tax Court and the Court of Appeals for the Fifth Circuit that during the years 1921, 1922, 1923, 1924 and 1929 petitioner's installment sales receivables were not a part of its surplus and that dividends paid from such receivables were a return of capital?

STATUTE INVOLVED.

The pertinent provisions of the Internal Revenue Code are set forth in the Appendix.

STATEMENT.

In 1920, petitioner, a Louisiana corporation, elected to report its income on the installment basis and has continued to do so in all subsequent years, filing its income tax returns for 1943 and 1944 under such method, as provided in Section 44(a) of the Internal Revenue Code. For both years, however, petitioner elected to file its excess profits tax returns on the accrual basis authorized by Section 736(a) of the Internal Revenue Code (R. 72).

Petitioner claimed an excess profits credit based on average earnings when making its return for the year 1943, but in a claim for refund substituted, without objection on the Commissioner's part, a credit based on invested capital (R. 72). Petitioner and the Commissioner agreed that $284,706.75 was paid in to the corporation as invested capital, but the Commissioner reduced petitioner's equity invested capital by $104,105.80 on the ground that certain distributions made during the years 1921 to 1924 inclusive and 1929 were paid out of capital and not out of accumulated earnings and profits (R. 72-73). The dividends in question were paid during the years and in the amounts as follows:

Year	Amount
1921	$ 22,636.11
1922	24,756.60
1923	19,493.99
1924	27,888.79
1929	9,330.31
	$104,105.80

The Tax Court was of the opinion that it was compelled to sustain the Commissioner's action by the decision of this Court in *Commissioner v. South Texas Lumber Company,* 333 U. S. 496, 68 S. Ct. 695 (R. 71-77) and the Court of Appeals affirmed on the same ground (R. 91-96).

The record does not disclose exactly how and why the dividend issue was raised by the Commissioner. During the years 1921 to 1924 inclusive and again in 1929, petitioner paid dividends to its stockholders from a surplus that was computed on the basis of its total assets, including, of course, its installment sales receivables. No one—company, stockholders or the Commissioner—suggested at the time that those dividends were non-taxable in the hands of the recipients, or that the corporation was paying back to the stockholders a part of their invested capital. The installment sales receivables when and as paid were brought into income and reported for income tax purposes. Almost all of these receivables were collected in the year immediately following the dates of sale (R. 62-69). That the corporation did not return the stockholders' capital to them during this period is evidenced by the fact that both capital and surplus, computed either on the basis of including or excluding installment sales receivables from the assets, were larger in 1929 than in 1921 (R. 1921 Balance Sheet, 44-45, beginning 1929 Balance Sheet, 58-59). The dividends, therefore, came from earnings, and they came from earnings reported for federal income taxes: there was no other possible source for this $104,105.80. Ordinarily, the fact that at this late date the Commissioner has charged the 1921 to 1924 and 1929 dividends to capital instead of to

surplus would make no difference taxwise: the residue of the income after payment of the dividends would be either in surplus or in the capital account. During the 1930's, however, petitioner suffered substantial losses and its surplus was exhausted. Consequently, the Commissioner's system of hybrid accounting, under which he eliminates all installment sales receivables from the company's assets, thereby creating a fictitious deficit so that the dividends must be allocated to capital, results in a reduction of capital without correspondingly increasing surplus. Properly including the receivables in the corporation's assets and charging the dividends to surplus, thereby leaving the capital account undisturbed (certainly usual and correct accounting and the only basis under Louisiana law on which the distributions could legally have been made) would have resulted in a deficit for the company at the beginning of the excess profits tax years. But deficits under Section 718 of the Internal Revenue Code may not be applied to reduce equity invested capital. Therefore the Commissioner sought to charge these dividends to capital, where they would reduce the company's credit, instead of to surplus where they would not.

At first impression this may appear to be an isolated, technical controversy, of importance to petitioning taxpayer only. Such is not the case. When and if it is determined that dividends paid from installment sales receivables are a return of capital—the final conclusion of the jurisprudence unless this Court reviews the question—many installment reporting corporations will be able to return to their stockholders in the form of non-taxable dividends all of the corporate earnings simply because they

have not yet been reported for federal income tax. Although this fact may have no juridical consequences, it indicates that the opinions below are accountingly erroneous and fiscally maladroit, justifiable only if there is a clear mandate in the Revenue Code to support them.

REASONS FOR GRANTING THE WRIT.

There are two grounds upon which this petition for a writ of certiorari is premised:

1. The Courts of Appeal are in confusion and conflict as to the application of this Court's decision in *Commissioner v. South Texas Lumber Company, supra,* to the interpretation of Sections 44, 115(l), 718 and 736(a) of the Internal Revenue Code, as evidenced by the following decisions:

(a) In petitioner's case, the Court of Appeals for the Fifth Circuit, relying upon its interpretation of the *South Texas Lumber Company* case, held that Section 736(a) of the Code excludes installment sales receivables from surplus in the years 1921 to 1929, even though that section refers only to such receivables outstanding on December 31, 1939. (R. 93.)

(b) In *Busch's Kredit Jewelry Company, Inc., v. Commissioner,* 179 F. 2d 298, the Court of Appeals for the Second Circuit held that installment sales receivables should be included in equity invested capital of a corporation provided that (1) it had reported its income for excess profits tax purposes on an accrual basis under Code Section 736(a) and (2) the out-

standing receivables did not result from sales made prior to 1940. (Pursuant to this reasoning petitioner's case would have been reversed in the Second Circuit, whereas it was affirmed in the Fifth Circuit.)

(c) In *John Breuner Company v. Commissioner*, 179 F. 2d 685, the Court of Appeals for the Ninth Circuit, citing the *Busch's Kredit Jewelry Company* case with approval, specifically held Treasury Regulations 111, Sec. 29-115-3, and 112, Sec. 35.736(a)-2, invalid in so far as they limit a taxpayer's right to include installment sales receivables of the type discussed in the *Busch's* case in equity invested capital.

(d) In *May, Stern and Company v. Commissioner*, 181 F. 2d 407, the Court of Appeals for the Third Circuit specifically refused to follow the reasoning of the Fifth Circuit in petitioner's case: "The Courts of Appeal for the Fifth and Ninth Circuits have accepted the Commissioner's view even since the argument of this appeal. We are unable to accept this construction." (Citing the *White* and *Breuner* cases in footnote.) Thereafter the Third Circuit considered the effect of Section 115(l) of the Revenue Code on the inclusion of outstanding pre-1940 installment sales receivables in equity invested capital. That portion of the opinion has no application to petitioner's case, inasmuch as the installment receivables pertinent to this controversy were derived from operations during the years 1920 to 1930 and, long before the excess profits tax was enacted in 1940, had been realized and reported for any and all federal income taxes then in effect. *No outstanding pre-1940 receivables are involved in this case.*

(e) In *Commsisioner v. McKay Products Corporation*, 178 F. 2d 639, the Court of Appeals for the Third Circuit, quoting the *South Texas Lumber Company* decision to the effect that earnings "in excess of 8% of a corporation's *working* capital" (emphasis supplied in opinion) are exempt from excess profits tax, held that "capital" is not a word of art but should be defined "in common parlance" as "the value of that with which the enterprise carries on its activity". This is directly contra to the deductions made by the Court of Appeals for the Fifth Circuit from the same opinion, and if applied to petitioner's case would result in a reversal of the decision.

All of these cases deal with the problem of determining a corporation's invested capital. With the exception of petitioner's case, they accept without question the premise that installment sales receivables are a part of a corporation's assets and hence automatically included in surplus. Apparently, only once before has the effect of dividend payments for installment sales receivables been before the courts for determination: *Commissioner v. Shenandoah Company*, 138 F. 2d 792, decided by the Court of Appeals for the Fifth Circuit, which sets forth a reasoned opinion directly contrary to the one arrived at in this case; and although this prior decision was urged upon the court both orally and in brief, it was neither distinguished nor mentioned in the opinion.

2. This case presents an important question of federal law which has not been, but should be, decided by this Court.

That question, which without comment has been answered in exactly opposite ways by the Court of Appeals for the Fifth Circuit, is: Are those particular accounts receivable of a merchandising company resulting from sales made on an installment basis an element of the corporation's surplus and as such available for dividends. The importance of the question derives from the fact that if such receivables are not part of a corporation's surplus dividends paid from them would be non-taxable in the hands of the stockholders, for they would represent a return of capital. Both courts below were of the opinion that this Court had decided the question in *Commissioner v. South Texas Lumber Company, supra,* but petitioner is unable to find any authority in the opinion itself for such a conclusion. The question is of such great importance in the administration of the tax laws that a determination of the exact issue should be made for the guidance of the Commissioner and a large group of taxpayers. Although this decision deals directly with the definition of capital for excess profits tax purposes, the determination of the question will of necessity apply to normal tax procedures inasmuch as Section 728, Internal Revenue Code, states that the terms in the excess profits tax law shall have the same meaning as when used in Chapter 1 of the Code.

CONCLUSION.

This Court has never passed on this issue and installment reporting taxpayers, relying upon the position assumed by the Commissioner in this case, may rightfully

conclude that in the present state of the jurisprudence they may declare non-taxable dividends from installment sales receivables provided only that the corporation's accounts show a deficit in surplus if such receivables are excluded from the assets. Since such a result would be of great detriment to the federal revenue, leading to extensive litigation with the Commissioner necessarily adopting the statutory interpretation urged by petitioner in this case, petitioner is of opinion that the question should be thoroughly reviewed and decided by this Court.

Wherefore it is respectfully submitted that this petition for writ of certiorari to review the judgment of the Court of Appeals for the Fifth Circuit should be granted.

Respectfully submitted,

FRANK S. NORMANN,
Attorney for Petitioner.

APPENDIX.

Internal Revenue Code:

Sec. 44. Installment Basis.

(a) *Dealers in Personal Property.*—Under regulations prescribed by the Commissioner with the approval of the Secretary, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price.

(b) *Sales of Realty and Casual Sales of Personalty.*—In the case of (1) of a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year), for a price exceeding $1,000, or (2) of a sale or other disposition of real property, if in either case the initial payments do not exceed 30 per centum of the selling price (or, in case the sale or other disposition was in a taxable year beginning prior to January 1, 1934, the percentage of the selling price prescribed in the law applicable to such year), the income may, under regulations prescribed by the Commissioner with the approval of the Secretary, be returned on the basis and in the manner above prescribed in this section. As used in this section the term "initial payments" means the payments received in cash or property other than evidences of indebtedness of the purchaser during the

taxable period in which the sale or other disposition is made.

* * * * * * * *

(26 U.S.C. 1946 ed., Sec. 44.)

Sec. 111. Determination of Amount of, and Recognition of, Gain or Loss.

(a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) *Amount Realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

(c) *Recognition of Gain or Loss.*—In the case of a sale or exchange, the extent to which the gain or loss determined under this section shall be recognized for the purposes of this chapter, shall be determined under the provisions of section 112.

(d) *Installment Sales.*—Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

(26 U.S.C. 1946 ed., Sec. 111.)

Sec. 112. Recognition of Gain or Loss.

(a) *General Rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * * * *

(26 U.S.C. 1946 ed., Sec. 112.)

Sec. 115. Distribution by Corporations.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * *

(l) [as added by Section 501 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, 1004] *Effect on Earnings and Profits of Gain or Loss and of Receipt of Tax-Free Distributions.*—The gain or loss realized from the sale or other disposition (after February 28, 1913) of property by a corporation—

(1) for the purpose of the computation of earnings and profits of the corporation, shall be determined, except as provided in paragraph (2), by using as the adjusted basis the adjusted basis (un-

der the law applicable to the year in which the sale or other disposition was made) for determining gain, except that no regard shall be had to the value of the property as of March 1, 1913; but

(2) for the purpose of the computation of earnings and profits of the corporation for any period beginning after February 28, 1913, shall be determined by using as the adjusted basis the adjusted basis (under the law applicable to the year in which the sale or other disposition was made) for determining gain.

Gain or loss so realized shall increase or decrease the earnings and profits to, but not beyond, the extent to which such a realized gain or loss was recognized in computing net income under the law applicable to the year in which such sale or disposition was made. * * *

* * * * *

(26 U. S. C. 1946 ed., Sec. 115.)

Sec. 718. [added by Section 201 of the Second Revenue Act of 1940, *supra.*] Equity Invested Capital.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

* * * * *

(b) *Reduction in Equity Invested Capital.*—The amount by which the equity invested capital for any

day shall be reduced as provided in subsection (a) shall be the sum of the following amounts—

(1) *Distributions in Previous Years.*—Distributions made prior to such taxable year which were not out of accumulated earnings and profits; * * *

* * * * *

(26 U. S. C. 1946 ed., Sec. 718.)

Sec. 728 [as added by Section 201 of the Second Revenue Act of 1940, *supra*]. Meaning of Terms Used.

The terms used in this subchapter shall have the same meaning as when used in Chapter 1.

(26 U. S. C. 1946 ed., Sec. 728.)

Sec. 736 [as added by Section 222 (d) of the Revenue Act of 1942, c. 619, 56 Stat. 798]. Relief for Installment Basis Taxpayers and Taxpayers with Income from Long-term Contracts.

(a) *Election to Accrue Income.*—In the case of any taxpayer computing income from installment sales under the method provided by section 44 (a), if such taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that the average volume of credit extended to purchasers on the installment plan in the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the volume of such credit extended to such purchasers in the taxable year, or the

average outstanding installment accounts receivable at the end of each of the four taxable years preceding the first taxable year beginning after December 31, 1941, was more than 125 per centum of the amount of such accounts receivable at the end of the taxable year, or if the taxpayer was not in existence for four previous taxable years, the taxable years during which the taxpayer was in existence, in either case including only such years for which the income was computed under the method provided in section 44 (a), it may elect, in its return for the taxable year, for the purposes of the tax imposed by this subchapter, to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, its income from installment sales on the basis of the taxable period for which such income is accrued, in lieu of the basis provided by section 44 (a). Except as hereinafter provided such election shall be irrevocable when once made and shall apply also to all subsequent taxable years, and the income from installment sales for each taxable year before the first year with respect to which the election is made but beginning after December 31, 1939, shall be adjusted for the purposes of this subchapter to conform to such election. In making such adjustments, no amount shall be included in computing excess profits net income for any excess profits tax taxable year on account of installment sales made in taxable years beginning before January 1, 1940. If the taxpayer establishes, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, that in a taxable year subsequent to the year with respect to which an election has been made under the preceding provisions of this subsection it would not be eligible to elect such ac-

crual method, the taxpayer may in accordance with such regulations elect in its return for such year to abandon such accrual method. Such election shall be irrevocable when once made and shall preclude any further elections under this subsection. For the taxable year for which the latter election is made and subsequent taxable years, income shall be computed in accordance with section 44 (c).

* * * * *

(26 U. S. C. 1946 ed., Sec. 736.)